Challenges And Opportunities For Cooperatives

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Mr. Chairman and members of the Committee, I appreciate the opportunity to appear before you today and discuss solutions to the challenges and opportunities facing producer owned and controlled businesses that are formed as cooperatives. My name is Steve Hunt. I am a fifth generation cattle producer and the CEO of U.S. Premium Beef (USPB), the first large-scale producer-owned beef marketing cooperative in the United States. I am proud of the history of independence that is a stalwart of the beef industry. Historically, this has enabled us to survive and prosper. Though, today and in the future it will be our ability to build on our independent legacy through cooperative efforts that may ensure our survival and prosperity for years to come. By cooperatively and strategically aligning ourselves among the many segments of the beef industry, we are better positioned to compete in today's increasingly competitive marketplace, respond to consumer preferences and improve the safety of our products. Our unique integrated strategy has allowed producers the opportunity to move up the value-added ladder enabling them to profitably sell meat and meals instead of cattle. Please refer to EXHIBIT A.

We will look back on this time as a watershed moment for a growing number of producer-owned cooperative businesses who are faced with the challenges of a restrictive cooperative structure and seeking a change. For producer owned ventures to compete and succeed today and into the future, they must have the ability to attract non-producer equity and diversify their business; both are restricted under the current laws governing cooperative structures. There exists today, alternative business structures in the form of

L.L.C.'s that provide the benefits of a pass through tax structure, link producer ownership to the delivery of a commodity, allow unlimited earnings diversification and provide for recruitment of outside capital; all while maintaining control in the hands of the producer. While the issues surrounding this topic can be complex, it is my intent to present solutions that will insure producers can organize and cooperate in a way that enables them to compete and survive.

Changes in the Marketplace

As one reviews the history of producer formed cooperative ventures, we see a structure that offered producers of commodities the opportunity to pool their resources, their commodities and capital, and move up the integrated value chain that no other structure allowed. Initially cooperatives were formed to deal with both social and economic needs in a much different marketplace. Today as we witness an acceleration of concentration among food industry participants, the need to achieve size, scale and market leverage is becoming paramount to their success. These changes require vast amounts of capital.

In the years ahead, cooperatives, like much of rural America, will face these serious challenges. Their customers and competitors are becoming larger, more sophisticated and utilize the latest technologies including biotechnology, information services and transportation. These evolving businesses can mass large amounts of equity through multiple sources. Under today's rules, cooperatives have only to look toward cash strapped producers to secure equity. The alternative is to leverage their business through debt equity; a strategy that has resulted in numerous public failures. One has only to read the headlines over the past several years to see the evidence of the growing number of agricultural cooperatives' inability to compete.

USPB Acquires Majority Interest in National Beef

While since 1997, USPB has enjoyed a successful partnership with Farmland Industries, in May of 2002, Farmland Industries' financial challenges, exasperated by its lack of liquidity, filed for bankruptcy. USPB ultimately acquired Farmland's interest in the National Beef partnership in August of this year through the bankruptcy process. As a result of the acquisition, USPB was able to secure a majority interest in the business.

However, due to the restrictions in attracting equity outside of a pool of cattle producers, USPB was forced to form its venture outside of the cooperative and seek outside investors as partners in the beef business. Had USPB been able to attract alternative sources of capital within the cooperative, we would have owned a larger percentage of the beef business and increased our odds of maintaining producer control into an uncertain and very competitive future. Additionally, in order to achieve a majority position, since equity capital was limited, we were forced to rely more heavily on riskier debt equity thereby leveraging the company.

Challenges of the Cooperative Structure

The wave of new marketing cooperative businesses that dotted the high plains and Midwest over the last decades provided a vehicle for producers to pool their commodities and capital and enter further processing or value added ventures. These entities were formed under the cooperative pass through tax principal. As long as the cooperative is fully owned and doing business for and with its qualified members, it will achieve a single tax much like a partnership or LLC. If it fails to maintain its producer ownership or pursue non-patron business, the cooperative will lose its tax efficiency and be taxed at both the company and producer level.

In recent years we have witnessed many farmer owned cooperatives fail or convert to other corporate structures. The cause for these two events is related. Producer / member equity can not compete with the capital intensive, value-added processing prevalent in food processing. Today's cooperatives are faced with an ever growing and consolidating marketplace. To succeed requires vast amounts of capital in order to achieve economies of size and market leverage. Very public failures, such as Farmland Industries, have been observed to be the victim of their own cooperative structure where essential capital sources of liquidity were limited to a narrow pool of already cash strapped producers. Likewise, many other cooperatives, seeing the challenges of raising necessary equity in the future, are considering converted to other business structures that allow alternative sources of non-producer equity.

Additionally, many successful cooperatives, like USPB, have been exploring alternative business ventures that fall outside the scope of patron or producer sourced income. These alternative businesses can be essential to diversify a cooperatives' business. In the case of USPB, we have invested in a food safety initiative that we plan to commercialize and license to other food processors thereby generating income not directly associated with producer cattle delivered, processed and marketed through their company. Once again, in other forms of pass through entities, the owners realize a pass through tax while engaging in a wide range of diversified businesses. As a cooperative, we are restricted from pursuing these alternative businesses.

While converting to an alternative business structure seems the simple solution; unfortunately, there exists several sizable barriers to converting from a cooperative to a partnership entity such as an LLC. Successful companies like USPB and its members could be assessed a tax on the gain realized through the termination required in current tax law. The tax liability itself further exasperates the lack of liquidity many cooperatives face.

Converting to a non-cooperative structure could also restrict our company from maintaining a bank relationship with CoBank. CoBank has been an important provider of credit and financial services to USPB since inception. Their knowledge and expertise in lending to agricultural producer-owned businesses nation-wide is invaluable. Their presence in a consolidating lending marketplace is key to maintaining access to credit and competition. Congressional action is needed to insure that farmer owned and controlled businesses, not formed as cooperatives, are eligible to borrow from CoBank.

Solutions

There is however, a solution to the challenges facing cooperatives considering a conversion. This solution is in the form of an amendment to the Internal Revenue Code providing for special rules for cooperative conversion transactions. In order to be defined as an association eligible for the special rules, the resulting association of the conversion would be required to maintain agricultural producer majority ownership and governance rights immediately following the conversion. I propose the following rule changes for eligible associations:

1. The conversion transaction shall not be treated as a sale or exchange of property
2. The shareholder or member of the cooperative shall not recognize a gain or a loss as a result of the conversion
3. The cooperative shall not recognize a gain or a loss as a result of the conversion

4. The basis of property that becomes property of the eligible association in the conversion shall be the basis of the cooperative before the conversion
5. The eligible association may adopt the same fiscal tax year as the cooperative before the conversion

A one-time conversion tax exemption on those cooperatives that convert to an LLC and still maintain producer control would allow for a viable solution to a critical problem. By requiring the converted entity to be majority owned and controlled by producers maintains the integrity of benefits flowing to agricultural producers. By targeting the most successful producer-owned ventures (those who have realized a gain) to aid in these changes, you have naturally selected a group who is most likely to succeed in furthering the integration of producers into value added markets. We must realize that achieving size and strength are essential to our success as **producer-**owned ventures and should not be considered a burden on the marketplace.

Conclusion

USPB, like many other successful producer-owned ventures formed as cooperatives, is facing significant challenges as it plans for its future. In order to survive and compete in our ever changing and consolidating food industry, we are going to need ready access to equity and have the ability to pursue diversified businesses.

Under the restrictions placed on the cooperative business structure, we are forced to consider alternative business structures that provide the needed flexibility to succeed. In order to provide us the opportunity to convert to these alternative structures, we need help in the form of an exemption from tax on gain realized at conversion and other cost savings such as maintaining the current fiscal year and an easing of securities requirements in the raising of equity. By requiring that the converting entity maintains producer ownership and control, you can be assured that this change will allow successful grass roots producer-owned ventures to succeed by showing up with the tools to compete with widely held public companies with unlimited access to equity.

We appreciate your continued support for our unique business. And, I respectfully ask that you consider supporting our need for changes in the tax rules that will facilitate changes necessary to continue the growth and development of producer owned ventures.

Thank you for the opportunity to testify before you today. I will be happy to respond to questions.

EXHIBIT A

The USPB Success Story

As early as the fall of 1995, midwestern producers from all segments of the cattle industry, seed-stock, cow-calf, farmer-feeder, and feedlot, began meeting to discuss the problems plaguing the current cattle marketing system and also to examine some solutions. After much research by a steering committee of these cattlemen committed to taking control of their own destiny, U.S. Premium Beef, Ltd. was formed. Founded on July 1, 1996, U.S. Premium Beef was structured as a new generation beef marketing cooperative, the first and only in the United States. Shortly thereafter, a business plan was established and a mission statement was adopted. This mission reads:

"To increase the quality of beef and the long-term profitability of cattle producers by creating a fully integrated producer-owned beef processing system that is a global supplier of high quality value-added beef products responsive to consumers' desires."

From there, more than 765 producers from 24 states committed both cattle production and capital to seek out the most economically feasible inroad into further processing and value-added products. After extensive research into the different alternatives of acquisition, building or joint venture, it became evident that the only viable avenue for producers to gain a greater share of their marketing dollar was through a joint venture.

In July of 1997, we announced that U.S. Premium Beef (USPB) had signed an agreement to enter a partnership with Farmland Industries, the nation's largest farmer-owned cooperative, to purchase 29 percent of Farmland's National Beef Packing Company. Farmland National Beef is the only producer-owned beef processing company, and additionally an international leader in value-added branded products.

During the fall of 1997 USPB mounted a stock offering drive through the United States. By December 1, 1997 our efforts were successful. We had commitments for nearly 700,000 cattle annually, and over $72 million in capital raised. The following week USPB began operations, buying more than 10,000 member cattle on an individual animal basis over a progressive carcass value based grid.

At USPB, we designed a progressive grid system to increase the quality of cattle and the returns to our producer owners by providing monetary incentives based solely on quality. Since we began delivering cattle in December of 1997, USPB cattle have exceeded industry quality levels, and our producers have earned significant premiums over cash price.

By working together to produce a better product, it is our intention to improve the overall image of beef and hopefully earn more of the consumer's trust and business with our efforts.

USPB Acquires Majority Interest in National Beef

USPB ultimately acquired Farmland's interest in the National Beef partnership in August of this year through the bankruptcy process. As a result of the acquisition, USPB was able to secure a majority interest in the business. However, due to the restrictions in attracting equity outside of a pool of cattle producers, USPB was forced to seek outside investors as partners in the beef business.

Current USPB Operations

To date, USPB and its members have marketed over 3.7 million cattle through its plants and beef company. Membership totals include over 1800 producers from all segments in 34 states. While still in its infancy, USPB has paid out over $64 million in cash premiums over the USDA reported live cattle market. In addition, our stock holders / members have realized earnings of over $80 million through the profits of the Beef Company they own. Stock, initially issued at $55 per share, now trades at $155 per share.

Additionally, every producer member is insured a competitive carcass merit grid pricing, carcass data on individual animals, transportation credit up to 110 miles or $6 per head, and livestock and meat consulting, all at no charge.

Our results have far exceeded expectations. The level of premiums has steadily increased over the past six years. This has occurred in great part due to the utilization of carcass data and the financial incentives in place through grid pricing. Any producer armed with the correct system and information can achieve these results.